

# ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Johannessen Analyst: Norm Catelli Bill Number: SB 1977

Related Bills: See Legislative History Telephone: 845-5117 Amended Date: June 26, 2002

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Exempt Transfer of a Mutual Water Company Assets to a Community Services District

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED

☒ February 22, 2002 STILL APPLIES.

OTHER - See comments below.

## SUMMARY

This bill would allow a mutual water company to transfer its property to a community services district (CSD) without being subject to corporate franchise or income tax.

## SUMMARY OF AMENDMENTS

The amendments would allow a mutual water company formed prior to September 26, 1977, to merge with a CSD in a nontaxable transaction.

## PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to facilitate the consolidation of water service with other community services (e.g., sewer, fire, police) by clarifying that the transfer of a mutual water company's assets to a CSD is tax-free to the company and the shareholders.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2002.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Brian Putler

7/22/02

## **POSITION**

Pending.

## **ANALYSIS**

### **FEDERAL/STATE LAW**

Internal Revenue Code (IRC) Section 501(c)(12) allows tax-exempt status to “mutual ditch or irrigation companies” which have at least 85% of their income collected solely for the purpose of paying the companies’ losses and expenses. In addition, the federal provision also encompasses local benevolent life insurance associations and mutual or cooperative telephone companies.

California does not conform to these federal provisions. Instead, California law allows tax-exempt status to mutual water companies under the homeowner’s association exemption in Revenue and Taxation Code (R&TC) Section 23701t. A general qualification of this section is that at least 60% of the gross income of the association or company consists solely of amounts received as membership dues, fees, or assessments from owners of residential units, residences, or lots.

Conversely, a specific qualification that would apply to mutual water companies is the requirement that revenue from metered water may not exceed 40% of the total gross income of the company. This restriction is an element of the 60% test mentioned previously because amounts paid for metered water are considered a payment for consumption of water, and not equalized membership dues, fees, or assessments.

California law generally conforms to federal law regarding corporate liquidations. In a liquidation transaction not involving a subsidiary being liquidated into its parent (so-called “332 liquidations”), generally both shareholders and the corporation will recognize gain on a liquidating distribution (where property, rather than solely cash, is being distributed). The liquidating corporation will recognize gain or loss on the distribution of property in a complete liquidation as if it had sold the property to the recipient, i.e., at fair market value. Amounts distributed to shareholders in a complete liquidation are treated as full payment in exchange for stock, with the shareholder’s gain or loss being measured by the amount by which the fair market value of the asset received exceeds (or is exceeded by) the shareholder’s basis in the stock.

### **THIS BILL**

This bill would allow a mutual water company to transfer to a CSD its assets and its obligation to provide service to the company’s shareholders, on or before January 1, 2008, in a non-taxable transaction.

### **IMPLEMENTATION CONSIDERATIONS**

Implementing this bill would not significantly impact the department’s programs and operations.

## LEGISLATIVE HISTORY

AB 1504 (Farr, Stats. 1991, ch. 454) added Chapter 2 (commencing with Section 61850) to Part 7 of Division 3 of Title 6 of the Government Code. Section 61850 of that chapter provides that the transfer of the assets and obligations of the Stonehouse Mutual Water Company to the Hidden Valley Lake CSD is not a transfer subject to taxation under the Corporation Tax Law.

## OTHER STATES' INFORMATION

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws do not provide an exclusion comparable to the exclusion allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

Revenue losses are expected to be negligible, not exceeding \$250,000 annually and beginning in 2002-03.

### Revenue Discussion

California does not conform to IRC Section 501(c)(12), therefore, a mutual water company generally is not considered a tax-exempt entity under California tax law. A mutual water company can receive tax-exempt status under R&TC Section 23701t if they are also a homeowners' association and meet certain requirements. According to departmental staff, however, a company that qualifies under IRC Section 501(c)(12) generally does not qualify under R&TC Section 23701t due to the differing requirements of each section.

According to the Secretary of State files in Lexis/Nexis, there are 712 active mutual water companies in California. Additional statistics on these companies are as follows:

- 345 companies were organized as nonprofit and 367 were organized for profit.
- 454 companies incorporated prior to September 26, 1977 (196 were organized as nonprofit, 258 were organized for profit).

According to Franchise Tax Board data, it appears that a vast majority of the nonprofit companies have been given tax-exempt status and a vast majority of the for-profit companies have not. It is unknown how many of these companies have received tax-exempt status under IRC Section 501(c)(12). However, this proposal could potentially apply to the 258 corporations indicated above.

Since this proposal only applies to companies organized prior to September 26, 1977, it is assumed a majority of the assets (i.e., property) would have very little basis and, under current law, would result in a gain on the transfer. There is very limited data available on the actual number of mutual water companies transferring assets to a CSD. The available data indicates that these transfers are not common. As a result, revenue losses are not expected to exceed \$250,000 annually, which would amount to roughly \$2.5 million in total income for all transfers in any given year.

## **LEGISLATIVE STAFF CONTACT**

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